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SUBJECT: CODEL GRAHAM FOCUSES ON CURRENCY AND PORT SECURITY

Classified By: EP Section Chief Simon Schuchat; Reasons 1.4 (b/d)

#### SUMMARY

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1. (C) Renminbi (RMB) valuation, port security, and mainland urban/rural disparity dominated the March 25-26 visit to Hong Kong of Senators Lindsey Graham and Charles Schumer. Hong Kong Monetary Authority Chief Executive Joseph Yam encouraged the Senators to continue pressing the mainland to liberalize currency policy but cautioned against seeking excessively rapid changes that would destabilize China's financial system and thereby harm the global economy. Hong Kong's former Chief Executive C.H. Tung counseled patience concerning financial liberalization, citing the rapid pace of China's economic reforms in recent years and underscoring the challenges posed to PRC leaders by growing income disparity and continued high rates of bad loans in the banking system. Seven financial strategists generally agreed that the renminbi (RMB) is significantly undervalued but assessed that the mechanics and political constraints faced by China rule out a quick resolution of the currency question. A demonstration of a pilot comprehensive container screening system enabled Hutchison Port Holdings to highlight for the Senators the degree to which global port operators are now 80 percent concentrated around firms from Hong Kong, Singapore, Dubai, and Denmark -- with implications for U.S. policy makers as they decide on how to engage the world on port security issues; the demonstration was followed by a visit to the Container Security Initiative (CSI) operations here. Local business leaders expressed concerns about the potential for instability on the mainland as resentment grows over corruption, land seizures, and income disparities -- all amidst increasingly free-flowing information, Internet restrictions notwithstanding. The International Republican Institute Resident Representative described the awkward balance that IRI must strike as a foreign NGO operating in China. END SUMMARY

#### VISIT DETAILS

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2. (SBU) Senators Lindsey Graham (R-SC) and Charles Schumer (D-NY) visited Hong Kong March 25-26 after traveling to Beijing and Shanghai. Accompanying the Senators were:

- o Matt Rimkunas, Legislative Assistant (Graham)
- o Kevin Bishop, Communications Director (Graham)

- o Jeff Haymond, Legislative Assistant (Schumer)
- o Risa Heller, Press Secretary (Schumer)
- o CDR Steve Vahsen, Military Escort

The Senators held the following substantive meetings (in order of agenda):

- o C.H. Tung, Former Chief Executive of Hong Kong
- o Joseph Yam, Chief Executive, Hong Kong Monetary Authority (HKMA)
- o Visit to Integrated Container Inspection System (ICIS) Pilot Demonstration
- o Visit to Container Security Initiative (CSI) Operations
- o Dinner hosted by the Better Hong Kong Foundation (BHKF)
- o Amy Gadsden, Resident Representative, International Republican Institute (IRI) (Graham Only)
- o Gathering with Financial Strategists (Graham Only)

HKMA: KEEP PUSHING, BUT CAREFULLY

13. (C) HKMA's Yam assessed the mainland's movement towards a more liberal financial system as understandably cautious. He made clear that Hong Kong sees it in its own interest for some elements of currency reform to move more quickly, particularly those aspects that might allow the city to benefit from expanded offshore RMB-related services. The HKG has made known to Beijing its interest in such an accelerated pace. Yam said the existing leadership is "unfortunately" slow in moving forward, in part because Premier Wen Jiabao is a consensus builder. People's Bank of China (PBOC) Governor Zhou Xiaochuan understands that excess accumulation of foreign exchange reserves implies that the time is now for bolder steps forward on the RMB, but Premier Wen is not "100

HONG KONG 00001285 002 OF 004

percent there," and Zhou's bureaucratic influence is limited. "If it was just Zhou, you'd be there," he said. Although Vice Premier Wu Yi met with the Senators in China and clearly impressed them, Yam commented that her responsibilities and knowledge with regard to reform of the financial system are limited.

14. (C) Yam said that slow liberalization of the currency system deprives China of access to services that would help channel funds in the most productive ways possible. Capital controls prevent money from flowing out of China to places like Hong Kong where talented intermediaries could put the funds to their best use. Yam observed that mainland investors are forced to invest domestically and are thus unable to purchase the financial instruments (listed stocks, bonds) of Chinese firms that obtain finance here. Beijing fully appreciates the importance of the financial system for growth and development but is very concerned about stability and thus remains cautious about moving forward. The leadership is now confronted by strains caused by rapid development (e.g., rioting in villages where land has been seized, mining accidents). While the U.S. should by all means continue to put political pressure on China, it is important to understand the downside risks should reform trigger disorderly adjustments. Further, although the Senators' proposed tariff legislation would not take effect for two years, markets could "telescope" the impact by reacting immediately.

15. (C) Yam said he was not sure whether the leadership in Beijing looked to Hong Kong as a place for experimenting with China's political direction. However, this is certainly the case on the economic side as is already evidenced by existing permissions granted for banks in Hong Kong to conduct limited RMB business. (Note: This includes RMB conversions, remittances, deposits, and transfers, but not loans or the issuance of RMB-denominated financial instruments. End Note.)

16. (C) Senator Graham told Yam that he had drawn several conclusions so far on his trip to China and Hong Kong: China

faces major challenges as it deals with growing income gaps between rich and poor; the 3 percent RMB appreciation since last July does not represent real reform but instead China's desire to avoid political conflict; China needs to take actions that will instill confidence that market disruptions caused by currency policy will be addressed; and the currency issue can be resolved in a win-win manner that can take us all to the next level of globalization. Senator Schumer told Yam that the currency question -- unlike intellectual property rights protection -- is something that the PRC central government has within its power to address now. He contrasted China's high savings/low consumption rates with the mirror image found in the U.S., concluding that changing the patterns found in both countries will be ultimately be part of the solution.

FORMER CHIEF EXECUTIVE: AVOID SHOCK THERAPY

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17. (C) C.H. Tung said that China's greatest challenge is managing urbanization as income disparity rises. This includes dealing with environmental degradation, addressing anger among the poor at issues such as land seizures, and providing a social safety net. Such issues compel Beijing to seek internal stability and a "peaceful globe" above all else. He encouraged the Senators to look at how fast China had changed in recent years and implored them not to judge China by the standards of U.S. democratic and economic development. Tung cited banking system reforms to date, compliance with WTO obligations, and rapidly growing imports as reasons to be more tolerant of China's pace of economic liberalization. He warned of financial instability should China move too quickly and asked that the Senators not try to "force shock therapy" on the PRC. Tung also spent a few minutes noting the importance to Beijing of the Taiwan question -- their number one issue -- and assessed Taipei Mayor Ma Ying-jeou -- a possible presidential candidate for the Kuomintang in 2008 -- as someone who could bring a hope of stability, unlike current President Chen Shui-bian who, in Tung's words, is "trying to be relevant" by pushing towards independence.

18. (C) Senator Schumer expressed concern that China is not

HONG KONG 00001285 003 OF 004

opening up its financial services sector quickly enough. Noting barriers to market access for Visa-branded credit cards, the Senator wondered aloud whether China is truly open to obtaining the best services and technology relevant to its development or whether it is trying to learn from the U.S. and then create a situation where its firms copy American practices but retain dominant access to the local market. Tung answered that the mainland's focus is bringing in investment and expertise from whatever source, and that this can be seen through the listing, for example, of Chinese banks in Hong Kong, a process that is occurring outside of the domestic economy and involves a wide range of foreign service providers and strategic investment partners.

INVESTMENT BANK ECONOMISTS: CURRENCY REFORM WILL TAKE TIME

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19. (C) Seven investment bank economists, all of whom held titles indicating a chief economist role involving China, generally agreed with Senator Graham's assertion that the RMB is undervalued, with four of them assessing that the currency is priced at least 15 percent below its appropriate market rate. Merrill Lynch's T.J. Bond cautioned that given the technical challenges involved, the pace of currency reform in China is unlikely to satisfy "any simple political argument."

Citibank's Yiping Huang echoed Bond, laying out the need to coordinate broader capital account liberalization with movement on the exchange rate. HSBC's Hongbin Qu said that given these constraints, it is important to watch out for excessive political pressure that sets back reform. BNP Paribas' Andrew Freris encouraged Graham to always leave

China with flexibility by not making excessively detailed demands that, for example, include both dates and percentage targets with regard to RMB appreciation. Goldman Sachs' Hong Liang said external pressure is a good thing but added that the selling point should be China's own interests.

¶10. (C) CSFB's Dong Tao suggested that one possible way to begin closing the trade deficit would be to ease up on visa restrictions. He noted that many other countries are now benefiting from growing Chinese tourism, not to mention the extensive purchases that these travelers make while traveling. Goldman Sachs' Liang seconded this view, commenting that the Chinese elites who wish to travel to the U.S. are not an immigration threat. (Note: Neither analyst acknowledged DHS Secretary Chertoff's recent comments to media that China is refusing to take back an estimated 39,000 citizens that have been found ineligible and deportable. End Note)

#### REVIEW OF PORT SCREENING TECHNOLOGY

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¶11. (SBU) The Senators visited Hong Kong International Terminals (HIT, part of the Hutchison Conglomerate) to see a demonstration of the Integrated Container Inspection System (ICIS), which has been set up as a pilot test here in Hong Kong by the U.S. firm Science Application International Corporation (SAIC). SAIC is awaiting a decision from the HKG on whether to buy ICIS. The U.S. Department of Energy has been working with the HKG on identifying options for extending the Megaports radiological screening program to Hong Kong by leveraging the capabilities of ICIS.

¶12. (SBU) Hutchison Port Holdings Senior Vice President Gary Gilbert showed the Senators how the ICIS system generates an "electronic folder" for each container as it enters the terminal yard. Trucks drive by scanning equipment that creates both an image of the container's interior and a radiation profile. Were the system fully deployed, the electronic folder could be made available to USG personnel at the destination port of entry, allowing the to prioritize issues involving ship arrivals and follow-on inspections.

¶13. (SBU) Gilbert emphasized the need for rapid scanning systems like ICIS, commenting that more goods are actually on the high seas at any given time than in transit at ports themselves. Consequently, any disruption -- from instituting screening procedures that slow down the movement of goods through ports to work stoppages - very quickly causes bottlenecks. 80 percent of the world's cargo volume is now handled at some point by firms from Hong Kong, Singapore, Dubai, and Denmark as a result of consolidation in the port

HONG KONG 00001285 004 OF 004

operator industry. Any U.S. port security strategy must therefore take into account the need to work with firms from these locations, said Gilbert. Hutchison facilities alone handle 45 percent of all U.S. cargo at some point before entry into the U.S.

¶14. (SBU) The Senators were then briefed by the ConGen's Container Security Initiative (CSI) Team Leader. CSI has been in operation in Hong Kong since May 2003. The 11 American personnel assigned here for CSI review all shipping manifests. They work with Hong Kong Customs inspectors dedicated to supporting the screening of containers for weapons of mass destruction. No WMD have been found to date but there has been the seizure of several million dollars worth of counterfeit merchandise as a result of CSI operations here.

#### BUSINESS LEADERS: ANXIOUS ABOUT INSTABILITY

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¶15. (C) Participants used a dinner hosted by the BHKF to express anxiety about the potential for serious instability

in China that could block the momentum of reform should economic and political liberalization move too quickly. Hang Lung Group Chairman Ronnie Chan said that a rapid currency appreciation could cause unrest given that China now is a place where "voices are loud" but that still lacks rule of law to address complaints. BHKF Executive Director George Yuen spoke of "priorities and varieties," explaining that the leadership in Beijing must constantly juggle what it wants to accomplish through reform with the variety of constituencies that are affected (e.g., different geographical areas, sectors, income rates, ethnic backgrounds). Commerce, Industry, and Technology Bureau Deputy Secretary Philip Yung observed that Hong Kong developed economically before it liberalized politically. Esquel Group CEO Marjorie Yang, noting corruption in China, questioned the capacity and sincerity of local government officials in deploying funds from Beijing aimed at improving the welfare of rural residents. Yang also asserted that Internet controls notwithstanding, the surge effect of chatter created by blogging means that word spreads quickly when events such as land seizures or disturbances occur.

IRI: IT'S NOT EASY TO BE AN NGO IN CHINA  
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¶16. (C) IRI Resident Representative Amy Gadsden told Senator Graham that all NGOs receive extensive scrutiny in China; she couldn't even pull her down her own email during her trip there last week. That said, IRI has a good record on the mainland; its proposals on extending land tenure rights were actually adopted by the government. While the Internet may offer some outlet for debate, there remains widespread fear that anything posted might someday lead to a "knock on the door." Gadsden said it is distressing to see President Hu Jintao be so hesitant about political reform. She noted instances where lawyers have been detained or harassed for taking on sensitive cases, especially those involving Falun Gong.

¶17. (U) Codel Graham provided a substantive clearance for this message.  
Cunningham